

Global Dispatch

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Brazil

Luxembourg holding company regime excluded from Brazilian privileged tax regime list

On 28 March 2011, Brazil's Federal Revenue Department issued a new regulation (ADE RFB 03/2011) removing Luxembourg holding companies from the Brazilian list of privileged tax regimes.

The privileged tax regime list was introduced by Normative Instruction 1,037/2010. Since its publication, various countries (including Spain and the Netherlands) have challenged their listed status by filing a formal claim with the Brazilian Federal Revenue Department. Although in some cases the claims have resulted in a temporary suspension of the applicability of the Normative Instruction, Luxembourg was the first jurisdiction to effectively be excluded from the list.

Although the reasoning for the aforementioned exclusion is based on the extinction of the so-called "1929 Holding Company Regime" (and its arguable tax benefits), ADE RFB 03/2011 excluded Luxembourg holding companies in general from inclusion on the list as a privileged tax regime, without exception.

Therefore, unless a new regulation is issued, no Luxemburg holding company will fall afoul of the Brazilian privileged tax regime list.

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Brazilian tax update: financial transaction tax increased, foreign loan registration process revised

Brazil increases tax on financial transactions again

The Brazilian government introduced Decree Nr. 7,457 on 6 April 2011 once again increasing the tax on financial transactions (*Imposto sobre operacoes financeiras* or IOF).

Based on the new Decree, the tax on the inflow of funds to Brazil related to loans or the issuance of bonds by Brazilian resident companies with a minimum average maturity of up to 720 days is increased to 6%. Under the previous Decree, Nr. 7,456, the

6% IOF was only applicable to loans with a minimum average maturity date of less than 360 days.

The changes introduced by Decree 7,457 are effective as from 7 April 2011.

Developments in the Brazilian Central Bank's foreign loans registration process

The Brazilian Central Bank issued Resolution Nr. 3,967/11. According to the regulation, the renewal, renegotiation, change of maturity date and transfer of foreign loan debts are now subject to a specific registration process with the Brazilian Central Bank (called *operacao simultanea de cambio*). As a consequence of the

registration process, potential IOF tax implications and costs may arise and will likely be considered by foreign lender companies before renegotiating or restructuring loans with Brazilian borrower companies.

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Canada

Canadian federal budget 2011 released

The Canadian federal Finance Minister introduced the government's fiscal 2011-12 budget on 22 March.

No specific international tax measures were announced in the budget. However, the following is a summary of some of the key business tax measures.

Corporate tax rates

The 2011 budget does not propose any changes to the enacted Canadian federal corporate income tax rates summarized in Table A.

Table A

Federal corporate income tax rates

	2011	2012
General corporate rate	16.5%	15.0%

Accelerated capital cost allowance

Continuing the theme of prior budgets, the Minister announced changes to capital cost allowance (CCA) rates:

- ▶ Manufacturing and processing equipment (Class 29): The temporary increase to a 50% CCA rate that was set to expire on 31 December 2011 has been extended for eligible assets acquired in 2012 and 2013. The half-year rule will apply, such that a full write-off may be claimed over three taxation years.
- ▶ Clean energy generation equipment (Class 43.2): For assets acquired on or after 22 March 2011, the budget proposes to amend Class 43.2 to include equipment used to generate electrical energy in a process in which all or substantially all of the energy input is from

waste heat from sources such as industrial processes. Systems that use chlorofluorocarbons (CFCs) or hydrochlorofluorocarbons (HCFCs) will not be eligible.

Stop-loss rules on the redemption of a share

The budget proposes extending the application of certain stop-loss rules to transactions occurring on or after 22 March 2011 in respect of the redemption of certain types of shares that were previously not caught by the existing stop-loss rules. A narrow exception will continue to exist with respect to shares of the capital stock of a private corporation that are held by a private corporation (other than a financial institution).

Corporate tax deferral using partnerships

Rules were introduced in 1995 to prevent individuals from deferring tax on business or property income by earning such income through a partnership that had a fiscal period other than 31 December. Corporations continued to enjoy a tax deferral on income allocated to them from partnerships that had a fiscal period that did not coincide with the corporation's tax year end.

The use of partnership structures to defer corporate tax has become increasingly common in recent years – especially since the announcement of reductions in corporate tax rates, which would achieve not only a tax deferral but an absolute tax savings by permitting the corporate partner to report income in its next taxation year at a lower tax rate.

Budget 2011 includes extensive proposals to eliminate this tax-deferral strategy in a manner that will spread, over a five-year period, the one-time tax cost from the collapse of the deferral. In addition, a formulaic approach has been proposed to include subsequent stub period accruals into income.

The proposed new rules will apply to all corporate partners that are entitled to more than a 10% income allocation from a partnership in a year. This threshold is determined after taking into consideration the income



entitlement for all related and affiliated parties. In general, the rules are similar to those introduced in 1995 for individuals.

Partnerships may elect to change their next fiscal periods to an earlier date. If the election is not made, or does not result in all corporate partners that are subject to the new rules having a year-end that is the same as the partnership's, corporate partners must add to their income an estimate of the partnership income arising in the balance of their own taxation year (stub period income). The stub period income amount is computed based on a proration of the partnership income allocated to them in that particular taxation year. This inclusion is deducted in their next tax year, when the actual partnership income for that fiscal period is reported.

More complicated rules apply to partnership structures with multiple tiers of partnerships that previously provided a longer-term tax deferral.

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China

China transfer pricing developments: new administrative systems for special tax adjustment

On 23 February 2010 China's State Administration of Taxation (SAT) released Guoshuihan [2010] No. 84, entitled "Notice of Briefing on Anti-Tax Avoidance Work in 2009" (Circular 84). According to Circular 84, one of the targets of the 2010 anti-tax avoidance work will be to establish a work system for special tax adjustment (transfer pricing adjustment). Ernst & Young has been communicating with the tax authorities on this topic and obtained the following information to share with our clients.

We understand that the International Taxation Department of the SAT is now in the process of developing internal administrative systems relevant for special tax adjustment (Systems). The SAT also intends

to collect feedback on the Systems from state and local tax bureaus at the provincial level throughout China.

Further to Guoshuifa [2009] No. 2: Implementation Measures for Special Tax Adjustments (the Measures), we understand the Systems intend to enhance the coordination and implementation of special tax adjustments by means including administration of Advance Pricing Arrangements (APAs) and Mutual Agreement procedures (MAPs), as well as a joint review procedure for significant special tax adjustment investigations.

The following lays out the SAT's intended Systems design to help taxpayers understand the SAT's recent focus and future trends in the area of special tax adjustments. The discussions below are based on our communications with tax authorities regarding the two proposed Systems. Please note that the final design of the Systems is subject to the SAT's discretion.

Reinforcement of SAT leadership and nationwide consistency

We understand that the SAT intends to strengthen the review of special tax adjustment results of audit cases that are deemed "significant." Specifically, the SAT intends to establish a joint review procedure to involve appointed national specialists in evaluating the preliminary adjustment results of significant cases.

The International Taxation Department of the SAT will identify and appoint anti-avoidance specialists from national bureaus for the preliminary review, and the International Taxation Department of the SAT will review and approve the final adjustment based on the opinion of the specialists' team.

The SAT intends to issue guidance on the definition of "significant" cases that will include: cases initiated by the SAT leadership; major nationwide joint investigation cases for certain industries or MNC groups; cross-regional unilateral APA cases; bilateral APA or multilateral APA cases; and other special tax adjustment cases determined by the International Taxation Department of the SAT.

The scope of significant special tax adjustment cases will include all major cases that can be used as examples in future special tax adjustment administration. It also appears to us that the International Taxation Department of the SAT is authorized to select any cases for joint review at its discretion. We believe that this proposed joint review system will improve the consistency of special tax adjustment results nationwide.

In connection with the mutual agreement procedure (MAP) for double taxation relief under tax treaties, MAP applications are likely

to be submitted directly to the International Taxation Department of the SAT. The local tax authorities would be principally responsible for actively assisting the International Taxation Department of the SAT in the process of international negotiation. We also understand that the SAT may involve local tax authorities in the actual negotiation of certain cases.

Through what we understand to be the SAT's latest initiatives in standardizing the procedures for special tax adjustments, it would seem that the SAT is resolved to improve the quality of special tax adjustment enforcement and to promote national consistency. It is recommended that companies review carefully any uncertainties in their tax arrangements and, if necessary, seek assistance from professionals to mitigate any potential tax risk.

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Hong Kong

Hedge fund managers: why transfer pricing matters in Hong Kong

In the past few years, Hong Kong has cemented its position as one of the largest hedge-fund centers in the world. As hedge fund managers set up or expand into Hong Kong, one of the tax issues faced is transfer pricing. The following outlines several common transfer pricing questions asked by hedge fund managers with operations in Hong Kong.

Can a Hong Kong investment advisor be compensated on a cost plus basis?

It depends. The cost plus method is a common approach for compensating a Hong Kong-based investment advisor. The method is practical and provides a steady level of compensation. As the Hong Kong cost base will include the salaries and bonus costs of the local individuals, it is arguable that the method links the compensation of the Hong Kong advisor with the overall performance of the group. This is so because individuals' compensation, particularly bonuses, is often directly tied to overall performance.

Despite the practical merits of this approach, the cost plus method is most commonly applicable to the pricing of support services. Thus,

it would appear inappropriate for application to investment advisory services that are one of the core activities of the group. Furthermore, if all employees (or partners) are based in Hong Kong, the cost plus method may result in revenues being left in the offshore fund manager. If there are no functions performed by people offshore, this would not be supportable from a transfer pricing perspective.

The method may, however, be appropriate if it can be argued that the group's key functions are performed offshore. In this regard this method may be more acceptable for US- or Europe-based hedge fund groups, which are expanding into the region and are providing significant support to their fledgling Hong Kong-based advisors. Likewise, if the business is in start-up and assets under management are beneath a certain threshold, the cost plus method may provide a reasonable result for transfer pricing.

Our capital raising takes place offshore: what does this mean for transfer pricing?

Raising capital, as distinct from ongoing investor relations, is often seen as a key function of the group. The ability to raise assets is critical in enabling a group to earn revenues. Therefore comprehensive capital raising functions could be compensated, for transfer pricing

purposes, with fees based on a percentage of assets under management earned from investors.

If part of this function takes place outside of Hong Kong, under Hong Kong's source profits tax regulations it may be possible to structure operations so that the income attributable to the offshore component of this function is not subject to Hong Kong corporate income taxation. However, caution is advised to ensure that any group seeking to separate Hong Kong and non-Hong Kong source income maintain sufficient documentation to support the income being classified as non-Hong Kong sourced. The group must also separate its cost base between onshore and offshore functions and the group must be ready to demonstrate that the functions in question were performed 100% offshore. A related issue is whether the offshore functions create a taxable presence in the location of service.

Do I need to prepare transfer pricing documentation and what should it include?

DIPN 46 emphasized TP documentation requirements. It notes that "*they [taxpayers] are required to draw up their accounts truly and fairly and may be called upon to justify their transfer prices and the amount of profits or losses returned for tax purposes in the event of an enquiry, audit or investigation.*"

Therefore hedge fund managers should prepare documentation commensurate with the size of their local operations. This should include details of the group's legal and operating structure, details on all applicable investment management functions performed, including those performed outside of Hong Kong to the extent they relate to Asia focused investments, and critical details of the transfer pricing methods used and why they are considered appropriate.

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Ireland/ Singapore

New proposed Ireland-Singapore income tax treaty moves forward

On 28 October 2010, Ireland and Singapore signed an income tax treaty and accompanying protocol (tax treaty). This is the first treaty concluded between the two countries. The tax treaty was ratified by Ireland in February 2011 and will enter into force following the completion of ratification procedures by Singapore. The tax treaty provisions will retroactively apply from 1 January of the year of entry into force. It should be noted that under Irish domestic tax legislation,

when tax treaties are signed but not fully ratified, tax benefits, such as certain withholding tax exemptions, applicable to tax treaty jurisdictions are available from the date of signing rather than the date of ratification. Accordingly, Irish source payments made to Singapore residents will enjoy Irish domestic tax benefits that are extended to tax treaty countries.

The tax treaty is generally drafted in line with the OECD Model Convention and contains favorable provisions which are expected to further promote investment and trading between the two countries.

Some important features include:

- ▶ Withholding tax is not applicable to dividend payments, reflecting the domestic laws of both Ireland and Singapore.
- ▶ Singapore generally levies a 15% withholding tax on interest and the general Irish domestic rate is 20%, although various domestic exemptions may be available in both countries. For example, under Irish law, interest payments made from Ireland to Singapore or a tax treaty jurisdiction can be paid gross, without deducting withholding tax, provided certain conditions are met. For interest payments made by a Singapore resident, the withholding tax is reduced from 15% to 0% for interest paid to the government of Ireland and 5% in all other situations.

▶ The maximum withholding tax on royalties is kept at 5%. Given that Ireland and Singapore are encouraging multinationals to develop and manage intellectual properties in their respective countries, a 0% withholding tax rate would have been more welcome. However, under Irish domestic legislation, royalty payments made to Singapore and other tax treaty countries can be made gross in certain circumstances.

▶ Capital gains are only taxable in the country in which the alienator is a resident, except for gains from the sale of immovable property and from unlisted shares deriving their value either directly or indirectly from immovable property.

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Israel

Israeli tax exemption on *Makams* and government bonds to be abolished

As part of the steps taken by the Bank of Israel and the Israeli Ministry of Finance to stop local currency appreciation, legislation aiming to cancel the existing tax exemption granted to foreign residents on income and gains from short-term *Makams* and government bonds has been proposed.

Currently, Israeli tax law provides an exemption from tax on income/gain derived by foreign investors on investments in short-term *Makams* and government bonds. This exemption is granted to encourage foreign investor activity in the Israeli capital markets. Nevertheless, according to a notice issued by the Israeli Minister of Finance, there is concern that this exemption is being exploited by players on the foreign exchange market to make a quick profit. Therefore, the proposed cancellation of the exemption is expected to somewhat diminish the attractiveness of investments by foreign residents in *Makams* and short-term government bonds that will in turn reduce the purchase of shekels, thereby weakening the local currency.

Part of the proposed legislation, drafted on 6 April 2011, is to amend Section 97(B2) of the Israeli Tax Ordinance (i.e., the section which provides the general exemption to foreign residents on capital gain from traded securities (except for REITs)) to exclude from the exemption capital gains from the sale of *Makams* and government bonds with maturity not exceeding 365 days from the date of their issuance. According to the drafted proposed legislation, the legislation will enter into force 30 days after its publication, in order to provide time for foreign investors to consider their response.

If the proposed legislation is passed, income / gains derived by foreign residents from short-term *Makams* and government bonds would be subject to tax at 15%-20% for individuals and up to 24% for corporations.

It is expected that more guidelines will be promulgated by the tax authorities (either by means of proposed regulations or tax circulars) in connection with this taxation, including in respect to gain calculation, procedures for claiming treaty protection and application to derivatives referring to such instruments.

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Italy

Italy releases draft decree on new tax regime to attract foreign investment

On 6 April 2011, the Italian Ministry of Finance posted on its website a first draft of the decree (Draft decree) aimed at providing implementation guidelines on a new tax regime to attract European investment.

The new rules (introduced by Article 41 of Law Decree No. 78/2010, then converted into Law No. 122/2010) should allow EU enterprises investing in Italy to pick one of the 27 existing EU tax regimes. The Draft decree was made public for discussion purposes only to invite any interested party to submit suggestions for amendments.

The Draft decree provides a first outline of the long-awaited regulations for the implementation of the so-called European attraction tax regime (*Regime fiscale di attrazione europea*) aimed at stimulating European investment into Italy by allowing the application of any one of the EU income tax regimes.

Under such rules, European Union companies and individuals which start a new business in Italian

territory should be able to choose and subject their Italian sourced profits to any of the existing EU tax regimes, including a regime different from the one applied in their own EU home country.

These rules may be of particular interest not only to EU investors but also to multinational groups with a European presence which intend to invest in Italy through their EU subsidiaries.

Current status of the law and potential developments

While, in principle, the law providing for the regime under discussion is already effective, actual

implementation is still to come pending technical regulations to be adopted by the Italian Ministry of Finance by way of a decree.

Among other things, some commentators have noted that the new rules aimed at attracting EU investments should not result in a mere tax incentive for European enterprises versus Italian ones. Such a favorable treatment could represent a distortion of free market competition in Italy and trigger a veto by the EU Commission. A contrary view is that the new rules should attract EU investors by representing a simplification in dealing with tax matters.

Consequently, some have suggested limiting the choice of the applicable tax regime to the one applied in the investor home country, i.e., allowing foreign EU enterprises to keep relying on their own tax rules even when investing in Italy (home state taxation system). Consistent with this, it has been suggested that the home state taxation rules should also be applied to the income generated by the new investor outside Italian territory and the application of any Italian tax rule should be avoided as much as possible (e.g., the black-list cost rule).

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Luxembourg

Luxembourg issues guidance on tax treatment of companies carrying out intra-group financing activities

On 8 April 2011, the Luxembourg tax authorities issued an administrative Circular (*Circulaire LIR n°164/2bis* or the April Circular) that provides additional guidance and clarification with respect to companies carrying out intra-group financing activities in Luxembourg.



This April 2011 Circular follows *Circulaire* LIR n°164/2 issued on 28 January 2011 (the January Circular). The January Circular included guidelines to be followed by taxation offices for issuing binding tax clearances to Luxembourg companies engaged in intra-group financing operations. The issuance of these clearances is made subject to meeting certain conditions in relation to the level of substance of these companies as well as meeting certain minimum equity requirements. The January Circular also provided specific guidance on the method for determining the arm's length price to be realized by an intra-group financing company.

The January Circular did not specifically discuss the position of those intra-group financing companies that obtained a tax clearance before the January Circular was issued. As Luxembourg tax clearances are interpretations of the applicable tax legislation, they would, in principle, be valid as long as the tax laws or administrative positions remain unchanged. The April Circular provides, however, that those pre-January Circular tax clearances will no longer be valid from 1 January 2012 onwards.

As a result, intra-group financing companies that obtained a tax clearance before the issuance of the January Circular should analyze the possible impact of the April Circular

on their Luxembourg financing operations. Where appropriate, their transfer pricing methodology may need to be updated. In addition, provided these companies comply with the conditions of the January Circular, they may request a new tax clearance on the remuneration to be derived from their intra-group financing activities. In line with the January Circular, this may require changes to their organizational and economic substance in Luxembourg and the preparation of transfer pricing documentation supporting the arm's length character of the remuneration derived from their intra-group financing activities.

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Netherlands

Dutch government issues tax policy paper discussing potential legislative changes

On 14 April 2011 the Dutch Ministry of Finance published a tax policy paper in which anticipated proposals to change certain Dutch tax rules are discussed. The tax policy paper

mentions the following main goals with respect to the anticipated changes: simplicity, solidarity and prevention of fraud. Reductions in various tax rates were announced (including the individual tax rate and the corporate income tax rate) while the taxable basis is expected to be broadened.

The tax policy paper outlines the government's intention to (1) reduce the Dutch corporate income tax rate from 25% to 24%, (2) introduce a limitation on the deduction of excessive interest expense incurred by acquisition companies which are subsequently joined in a fiscal unity (i.e., tax consolidation) with the acquired Dutch target company and (3) move to a full territorial tax system for the income of foreign branches.

Furthermore, the tax policy paper discusses the government's intention to (1) increase the lower VAT rate applicable to certain goods from 6% to 19% and simultaneously (2) reduce the progressive individual income tax rates, which will reducing tax costs for employers and employees.

The Dutch State Secretary of Finance confirms that there is no intention to abolish the dividend withholding tax.

The tax policy paper further announces that the rules governing foreign substantial interest holders will be amended. Although the tax

policy paper does not discuss what type of changes are contemplated, the anticipated proposals should be seen within the context of the request by the European Commission to the Netherlands to change its legislation which exempts domestic companies from tax on their income from substantial interests, but which taxes companies established elsewhere in the EU and EEA on income from substantial interests in a Dutch company if the substantial interest does not belong to an enterprise carried on by that EU or EEA company. One may expect the anticipated changes to be primarily a concern for portfolio shareholders.

Lastly, the tax policy paper mentions that legislative proposals are expected in the third quarter of 2011. As the legislative process advances, Ernst & Young will continue to provide updates on any developments.

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Norway

Norway proposes new rules for cross-border reorganizations and exit taxation

On 25 March 2011, the Norwegian Ministry of Finance presented a White Paper on tax-free cross-border reorganizations based on continuity in tax values/basis.

The White Paper proposes establishing by law that certain cross-border reorganizations can be carried out tax-free based on tax continuity, namely:

- ▶ Mergers/demergers (divisions)
- ▶ Share-for-share exchanges (share swaps)
- ▶ Migration of corporate tax residence
- ▶ Intra-group transfer of assets, etc. (incorporation of branches, etc.)

The proposed rules on tax-free share-for-share exchanges and intra-group transfers of assets, etc., apply to reorganizations both within and outside the European Economic Area (EEA). The rules do not apply to companies in low-tax countries and wholly artificial low-taxed companies within the EEA taking part in the reorganization.

In the case of mergers, demergers and migration of corporate tax residence, the Norwegian company's assets must be transferred unchanged to a Norwegian permanent establishment (branch) of the receiving foreign company in order to avoid full and immediate taxation. However, if the assets are not transferred to a Norwegian branch and thus moved out of Norwegian tax jurisdiction, the general rules dealing with the transfer of assets abroad will apply (exit taxation). These rules generally provide for tax deferral and tax annulment after five years. However, any unrealized gain on intangible assets (including goodwill) and

current assets will become subject to full and immediate exit taxation.

The Ministry of Finance is of the opinion that the proposed changes will bring the Norwegian rules into compliance with the EEA agreement. However, the EFTA Surveillance Authority (ESA) is expected to consider the legality of the new proposed rules under the EEA agreement, especially the rules imposing full and immediate taxation on intangible and current assets.

If the rules are adopted, it has been proposed that they will enter into force immediately and with retroactive effect from 1 January 2011.

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Spain

Spanish Supreme Court decides against thin cap rule

A judgment of the Spanish Supreme Court dated 16 March 2011 declared that the Spanish thin capitalization rule does not apply to a loan granted by a foreign bank where the loan has been guaranteed by a related party that is entitled to benefit from a double tax treaty concluded by Spain that contains a non-discrimination clause.

Further, the Spanish Supreme Court provided guidance as to when a letter of comfort could trigger thin capitalization restrictions.

Specifically, letters of comfort should only be seen to constitute indirect borrowing for Spanish thin capitalization purposes where there is an effective transfer of funds from the Spanish subsidiary to the foreign parent.

Although the judgment refers to a situation governed by the former thin capitalization rules, it is reasonable to understand it to apply to the rules currently in place as well.

The Supreme Court's decision on the interplay between the non-discrimination clause in a treaty and

the Spanish thin capitalization rule confirms the criteria followed in a former judgment, although that was a case with an EU resident parent. The decision is of key importance since it supports the position that the Spanish thin capitalization rule is not applicable to loans from non-Spanish resident related lenders that are eligible to benefit from the provisions of a double tax treaty containing a non-discrimination clause.

Taxpayers should review their thin capitalization position in light of this judgment. Depending on the particular circumstances, this judgment could also provide support for revisiting prior year tax returns that include thin capitalization adjustments.

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Turkey welcomes new Commercial Code

The new Turkish Commercial Code No. 6102 has been accepted by the Grand National Assembly and published in the Official Gazette on 14 February 2011.

The Commission in charge of replacing the former half-century-old commercial code consisted of judges, scholars, practitioners and representatives of non-governmental organizations and public institutions. A total of 631 meetings were held during its working period of more than five years. The drafts were shared with the public and opinions from all relevant institutions and organizations were gathered and discussed.

The new code integrates Turkish commercial regulations with EU legislation and puts into effect generally accepted financial reporting and auditing principles, paves the way for democracy among shareholders, introduces new concepts such as transaction auditors and facilitates the use of information technology tools. The new Commercial Code will enter into force on 1 July 2012, with a transition period established for a majority of its provisions.

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